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On the Road to Deflation

"What is the true criterion of a creation of credit which shall be non-inflationary? We have found the answer to lie in the preservation of a balance between the rate of saving and the value of new investment. That is to say, bankers are only entitled to create credit if the net effect of such credit creation is not to raise the value of new investment above the amount of current savings of the public; and, similarly, they will lay themselves open to deflationary action unless they create enough credit to prevent the value of new investment from falling below the amount of current savings."

J.M. Keynes, A Treatise on Money, 1930

We are now facing deflation actual or imminent — in most of the developed world. Japan is in the midst of outright deflation; the Tiger economies are beginning to follow suit; Europe's weak demand and endangered exports make its economies prone to deflation. The principal holdout to this trend has been the U.S.

This, of course, is because the U.S. is actually experiencing the most dramatic inflation in its history. But the inflation in the U.S. is of the worse kind. It is rampant asset inflation, the same brand that led to the deflationary collapse of Japan and the Tiger economies. The principal difference is that, in the U.S., the asset bubble is translating into unsustainable overconsumption, while in Asia it went into unsustainable overinvestment in industrial plant and property.

Full-blown deflation cannot and will not come in the U.S. until the stock market crashes, but the crash is only a matter of time. In this issue we examine the competing forces of inflation and deflation in the global economy to determine what might be in store for the U.S. after the crash.

We also examine two of the most overbought sectors on Wall Street, high tech and banking. We find high tech under immense pressure from the deflationary forces coming out of Asia, evidenced recently by December's double-digit declines of the sector's leaders. Banking, for its part, has not yet begun to correct, but we find it equally vulnerable. More importantly, perhaps, the decline of both these sectors will have devastating effects on the economy. High tech has been a major component of U.S. economic growth, while banking has not only recklessly financed the current global bubble, it has been a leading participant in the speculative markets.

Our conclusion is that once the crash does come, the ensuing recession in the U.S. will be of a severe, prolonged, and possibly deflationary nature.

AFTER THE FINANCIAL SHOCK THE ECONOMIC SHOCK

Southeast Asia has suffered a ferocious financial shock. Within a few months, hundreds of billions of dollars in financial wealth have disappeared, as currencies and asset markets crashed. It is a meltdown of unparalleled dimensions, potentially dwarfing the 1930 catastrophe. Nevertheless, we should realize that this financial disaster is only the prelude to an economic shock that will yet reverberate through the region and the rest of the world for a long time to come. Things will stabilize eventually — they always do — but when and at what point?

Three years ago, Mexico was "bailed out" by the booming U.S. financial markets and economy — no more, no less. It was a "cyclical" recovery "papering over" Mexico's ongoing structural shortcomings that will wait for another day to cause more serious problems. Trying to get some idea of what to expect in economic and financial difficulties, we look at Japan as the model case. Internally, Japan and Southeast Asia face exactly the same kind of problems: the same glut of manufacturing capacity from years of excessive investment, the same apocalyptic wealth and liquidity destruction from collapsing real estate and equity values, the same fragile banking systems ravaged by masses of bad loans, and the same overleveraged corporate balance sheets.

Yet there are important differences to be kept in mind. To start with, it appears the maladjustments in Southeast Asia are worse than in Japan. Second, the resources of the SE Asian economies to cope with financial calamities are far more limited. Third, and worst of all, as deficit and debtor countries, they are trapped with ludicrously high interest rates. Korean rates of 25 percent compare with Japanese rates of less than 2 percent.

There is much talk that these countries must undertake draconian monetary and fiscal measures in order to restore market confidence. True, but before these economies begin a sustained recovery, such measures are sure to worsen the crisis. On the other hand, the rest of the world has yet to face the fact that there is but one means to cushion the economic pains confronting these countries, and that is to absorb from them a deflationary export boom.

But which are the countries to accommodate an Asian export drive? Japan? Europe? Definitely not. They depend themselves on export-led recoveries. And America? As long as the U.S. economy seems to be booming, soaring imports may be hailed as the medicine that helps prevent rate hikes. But wait, what will happen when the economy sharply slows later this year? In our opinion, protectionist fervor will return in full force.

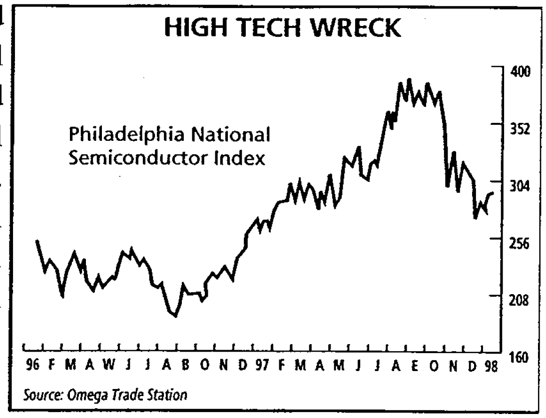
In its Annual Report "World Economic Outlook", published in October 1997, the International Monetary Fund (IMF) described a world economy as one in excellent shape: "solid growth with low inflation in the United States and the United Kingdom; a strengthening recovery in Canada; a broadening of recovery across continental western Europe;... robust growth trends in most of the developing world, particularly in China and much of the rest of Asia;... and perhaps a beginning of growth in Russia and the transition countries as a group."

In a more recent report, the IMF admits that the "extent of the financial shock to hit Asia has taken the international lending agency by surprise. Neither economic forecasts nor asset prices in the financial markets foretold the depth and breadth of the crisis to come." The report then added, "When economic conditions remain generally good and when private capital is flowing at a record pace and on very attractive terms, it is easy to believe that the good time will continue."

THE GLOBAL TROUBLE SPOT: HIGH TECH

As to our own assessment, the following quote from our September 1996 letter speaks for itself: "What makes the Asian Tigers so interesting is that they are universally seen as an outstandingly healthy group of countries with the brightest of futures ahead of them. In fact, they may be teetering on the edge of a cliff."

What had triggered our critical comment was the observation that these countries in 1996 had run into soaring trade deficits owing to collapsing prices for their high-tech exports. On this point, we wrote: "The Tiger economies now are an integral part of the U.S. and the Japanese financial bubbles. While America has overinflated consumption, the Tiger countries, like Japan, have been overinflating their industrial base — pouring hundreds of billions of dollars into production facilities for high-tech products that are completely dependent on export markets."



Source: Omega Trade Station

In short, we saw in the Tigers' sliding export growth and sharply deteriorating trade balances the early signs of a global downturn in technology after a prolonged period of unprecedented overinvestment. In this light, this was not just a brewing regional crisis but the beginning of trouble in technology on a global scale. And that is, indeed, the channel through which the Asian crisis will over time profoundly affect the rest of the world. In particular, it will have a severe impact on the U.S. economy, where high tech has been a main contributor to growth. It astonishes us how little attention this particular aspect still receives.

But, moreover, we have never shared the prevailing complacent view, which holds that the world economy is currently in excellent shape. For us, it is self-evident that where there has been so much unfettered monetary looseness and financial speculation there simply can't be all economic and financial health. This, inevitably, implies the emergence of "bubbles". Growing imbalances, both between and within countries, have been immersed in floods of loose credit. After all, the catalyst for the burst of the bubble in Southeast Asia came not from any monetary tightening, but from deteriorating trade balances causing foreign creditors to restrict their lending to these countries.

Apparently, this perception of an eminently healthy global economy has been substantially fostered by the general, spectacular decline of inflation rates. Among American economists, it is gospel that low inflation rates, in particular when synchronous with strong economic growth, are the closest token of an exceedingly well balanced and healthy economy. According to this line of thinking, then, loose money is fully justified. Oddly, however, the worst economic crises in this century — the U.S. depression in the 1930s and the Japanese depression since 1990 — have occurred precisely in the wake of prolonged periods of such ideal constellation, that is strong economic growth with zero or near-zero inflation.

These same people, among them the world economic and financial leaders, never recognized that the roaring boom of the Japanese economy in the late 1980s, with its low inflation rates, was "bubble-bred". They came to recognize this fact only after the bursting bubble shattered the banking system and the whole economy. The same blindness prevailed before the sudden eruption of the Mexican crisis of 1994-95, and now in the case of Southeast Asia! In all three cases the economies concerned had been considered models of economic strength and financial health. Yet, virtually over night, their banking systems were on the verge of collapse.

INFLATION OR DEFLATION?

A battle has been raging for some time on this issue. On the one hand, most economists believe that the real bogy of the global economy and the financial markets is and always will be inflation. On the other hand, dissenters proclaim that the benchmarks have truly and definitely changed and that various recent developments are calling for long-term deflation.

The inflation protagonists focus on the global money and credit glut that has for years been flooding the world economy and financial markets. But instead of fueling inflation in the prices of goods and services, this money and credit deluge has overwhelmingly poured into the financial markets, stoking runaway inflation there — asset price inflation. In this view, the excess liquidity must eventually spill over into the real economies, as presently witnessed in particular in the United States and Britain.

What first induced the talk of possible deflation, we are not quite sure. It was, we suspect, the steady

decline in U.S. producer and import prices, on the one hand, and the realization that a lot of excess capacity in manufacturing has globally been built up, on the other. For good reasons, the Asian crisis has given this talk of deflation new impetus.

Ironically, Wall Street was quick to seize upon the same argument, but, of course, with a bullish twist. It is accepted that the Asian crisis, through its impact on trade, will exert a certain drag on the U.S. economy, albeit too little to really hurt — yet just sufficient to cap inflation and thus obviate any further need for a rate hike. Rather, investors ought to thank the Asian crisis for the new strength in global bond markets, which, in turn, has provided invaluable support for equities.

DEFLATION ON THE ADVANCE

Until quite recently, frankly speaking, we were loath to give the question of deflation any thought, considering that the world economy and in particular its financial markets have been drowning in an excess supply of credit and money. But the tremors on the Far East have set the alarm bells ringing for us.

Japan, meanwhile, must be regarded as a clear case of outright deflation which, in essence, is no longer cyclical but has become structural. Once the fiscal stimulus was withdrawn, the economy instantly relapsed into recession. According to OECD estimates, Japanese real GDP grew last year by 0.5 percent. But one full percentage point of economic growth has been provided by exports, while domestic demand actually contracted by 0.5 percent. In the absence of this strong export outlet, the Japanese economy with all its excellent fundamentals and ultra-low interest rates would be in depression.

We begin to pose the same question about France and Germany. In both countries, the extreme loose monetary stance has hardly worked any better than in Japan, except for creating booming financial markets. Presently, it is widely hailed that their GDP growth has in 1997 accelerated to 2.3-2.4 percent, from 1.3-1.4 percent the year before. Looks impressive, doesn't it? Yes, but virtually nothing of this gain has come from final domestic demand; everything from inventories and exports. These are definitely not self-sustaining recoveries. Here too, the more appropriate question is: Where would the two economies be without the big support they get from soaring exports? Could this be deflation?

And what about the Southeast Asian crisis? Are they going the same way as Japan — into demand and debt deflation and depression? Or are things perhaps not so bad after all so that these countries may get away with a rather brief 1994-95 Mexican-style debt crisis?

WHAT IS DEFLATION, ANYWAY?

What is the greater danger for the world economy — inflation or deflation? With this question in mind, we have done a comprehensive investigation of actual inflationary and deflationary trends in the world economy. First, though, a key point needs clarification. It concerns the essence both of deflation and inflation.

Conventionally, deflation is today perceived as a decline in prices, just as inflation is perceived as a persistent rise in prices. In past letters, we have regularly attacked this superficial perception of inflation. In like vein, we disagree with the corresponding interpretation of deflation as a mere price phenomenon. In line with the reasoning of the Austrian School (Mises, Hayek, et al.), we have always stressed that inflation's most important and most dangerous ill effect is not the rise in the price level, but the circumstance that the credit excesses lead to serious distortions in the demand and output structures. These distortions mainly breed the ensuing recession.

As an aside, this view about inflation used to be shared by many American economists of the elder generation. An example is the following quote from Professor Raymond Saulnier, chief economist for President Eisenhower: "Expansionist policies carried to excess result not only in an outbreak of inflation but in structural imbalances that sooner or later make a recession a virtual necessity." The present simplistic approach to inflation is an upshot of late monetarism.

By contrast, deflation implies in essence a contraction of demand. Its regular source is an excess of savings over investments. Such savings evaporate in business losses. In contrast, a rate of investment continuously greater than the rate of available savings, financed out of credit creation, engenders the inflationary boom. By the way, these definitions are by no means our personal invention. They are an offshoot of European "classic" economics.

THE LESSON OF THE GREAT DEPRESSION

Actually, there is a dramatic historical test case for this bone of contention. That is the U.S. boom of the 1920s and the prolonged Great Depression that followed. In his Monetary History of the United States, Professor Milton Friedman describes the 1920s as a period of "relative deflation" because consumer prices remained stable while wholesale prices fell at a rate of 1 percent per year. For Friedman, this was, until the stock market crash, an economy of perfect health. Therefore, he concludes that the monetary collapse from 1929 to 1933 was not an inevitable consequence of what had gone before. Verbatim: "It was the result of the policies followed during those years... Though the Fed proclaimed that it was following an easy-money policy, in fact, it followed an exceedingly tight policy."

In contrast, the pundits of the Austrian School did forecast the economic debacle long before it started because they looked beyond the price indexes at a credit expansion that appeared to them vastly excessive. While this rampant inflation in borrowing and lending did not express itself in a rising price level, it did strikingly manifest itself in the booming financial markets as well as in unsustainable boosts to investment and consumption. For the Austrians, these structural maladjustments were the decisive ill effect that would inevitably lead to depression.

But how could there be a stable price level, if there was rampant credit inflation? Very simple, according to the Austrians: "The inflationary effects of the credit excesses were on the micro-economic level offset by big efficiency gains and modest wage rises, in other words, by sharply falling costs." Between 1919 and 1929 overall productivity per man hour in manufacturing rose by some 70 percent, so goods prices ought ordinarily to have fallen. But that is what the credit inflation prevented. The opinion that the stable price level rendered the credit inflation harmless turned out to be fatal.

THE DECISIVE FACTOR: CREDIT DEADLOCK

Earlier, we explained that deflation — generally speaking, a contraction of demand — arises from an excess of savings over investments. Given in every country a limited supply of current savings, a compensatory credit expansion is needed in order to convert the nation's thrift into investment spending. This takes place either through bank lending or through the securities markets. The persistent change from excess savings to excess investments used to make for the typical pattern of the business cycle.

Only once in history has this business cycle pattern broken down for a prolonged period — in the Great Depression of the 1930s. Despite rock-bottom U.S. interest rates, investment spending remained deadlocked for almost ten years. We have chosen to recall this disastrous American experience because we see an eerie, if less dramatic, parallel today: deflationary Japan.

This brings us to another controversial point between American economists and the European "classic" economists, which is of the greatest importance for an assessment of the situation today. It concerns the question of what chiefly caused the Great Depression of the 1930s. Was it the result of grossly inept monetary policies after the stock market crash? Or was it more or less the inescapable upshot of severe maladjustments that had developed during the boom years? For Milton Friedman, the Great Depression had but one cause: grossly inept monetary policies after the stock market crash of 1929-30. With better policies, in other words, the Great Depression could have been avoided. In the same vein, by the way, he just recently accused the Bank of Japan of deserving much of the blame for the current parlous state of the Japanese economy.

The Austrian School is diametrically different in this respect. It basically says that the depth and severity of any recession or depression depends crucially on the magnitude of the economic and financial maladjustments that have accumulated in the preceding boom. In this view, in other words, the exceptional severity of the Great Depression of the 1930s was primarily due to the fact that domestic and international lending for investment, consumption and financial speculation had gone to unprecedented excess.

Good or bad policies during the following crisis may, of course, alleviate or aggravate the inevitable painful adjustment process, yet its depth and severity is for the most part predetermined by the extent of excesses in the prior boom. What rapidly spread deflation and depression around the world in the 1930s was the complete collapse of international lending and with it the complete collapse of world trade.

"PUSHING ON A STRING"

Milton Friedman's recent article in *The Wall Street Journal* about the Bank of Japan is indicative of the thinking of many American economists: "There is no limit to the extent to which a central bank can increase the money supply if it wishes to do so. Higher monetary growth will have the same effect as always. After a year or so, the economy will expand more rapidly; output will grow; and after another delay, inflation will increase moderately. A return to the conditions of the late '80s would rejuvenate Japan and help shore up the rest of Asia." In brief, Mr. Friedman completely ignores the structural maladjustments inflicted on the economy by the preceding boom. Money growth is everything.

And how to achieve the desired money growth? For Milton Friedman that's the simplest thing: "The Bank of Japan can buy government bonds on the open market; paying for them with either currency or deposits at the Bank of Japan, what economists call high-powered money. Most of the proceeds will end up in commercial banks, adding to their reserves and enabling them to expand their liabilities by loans and open market purchases. But whether they do so or not, the money supply will increase."

This is another issue of crucial importance, in which American and European economists fundamentally disagree. Here the usual answer of European economists of a generation ago would have been: "Yes, central banks do create deposits by buying government bonds. But these are deposits at the central banks to the credit of the commercial banks. Unless the commercial banks, on their part, use the resulting increase in their cash reserves to expand their loans or their security holdings by a large multiple of the additions to their reserves, the monetary easing is thwarted." Then, the central banks will find themselves "pushing on a string," as the saying was in the 1930s.

In short, what counts is never the action of the central bank but the further action by the banking and financial system in creating credit for their customers, and ultimately, what use those customers are going to make of their borrowed money. We must not forget that today a very large part of lending activity serves to fund financial speculation which generally does nothing to increase the gross national product. Cheap money fails to become effective, except for creating booming financial markets.

But even bank lending is by no means a unilateral act. For a credit expansion to materialize, it needs in addition to banks that are willing and capable to give credit also customers who are willing and creditworthy to take credit for spending on consumption or investment. A lack of credit expansion may be caused by an insufficiency of either. In serious cases, the two largely go together. Ailing banks tend to imply ailing customers.

ASIA IN FULL-FLEDGED DEFLATION

We alluded to Japan as a clear and serious case of developing deflation. Considering the diversity and magnitude of economic and financial maladjustments incurred by the whole of Far East Asia, embracing China, Korea and the so-called Tiger countries, we have no doubt that they will join Japan on the road into protracted deflation. Given their huge foreign debts, they are in even greater trouble.

Common to them all is that their economies and financial systems are geared to extremely high savings and investment ratios ranging between 30-35 percent of GDP. But with lax monetary policies and the tolerance of unfettered capital inflows, they kindled vast investment excesses. The ultimate legacy of this is now huge malinvestments, crashing collateral values and equity bases, and mountains of bad loans involving in their wake a truly colossal destruction of wealth and liquidity.

The Asian bubble has definitely been pricked, and the process of financial and economic adjustment — with all its gory, attendant impacts — has been set in motion. But, to be sure, the financial meltdown that has taken place is not the height of the crisis but its precursor. We see protracted, deep recession and full-blown banking crises across the whole area.

A WHIFF OF DEFLATION IN EUROPE

What, then, about Europe and America? Heading for deflation or inflation? For the time being, we see a mixture of both. A number of major economies — U.S., U.K, Canada, and others — are enjoying fairly vigorous growth, hitting domestic capacity limits. But others are struggling to recover. If it were not for booming exports, they would be close to stagnation, even with extremely loose money and low interest rates. The outstanding examples are Germany, France, Austria, Italy, and Switzerland. Yet, soaring financial markets and declining inflation rates are common to all the countries listed in the table, except Japan, whether their economies are booming or lagging.

To repeat first: The essence of deflation is a contraction of demand caused primarily by an excess of savings over investments. But this deflationary imbalance can be corrected in two ways: either by an increase of investment up to the level of savings or by a decrease of savings down to the lower level of investment. By distinguishing between these two ways, we have made an interesting discovery about the economic situation in America and Europe.

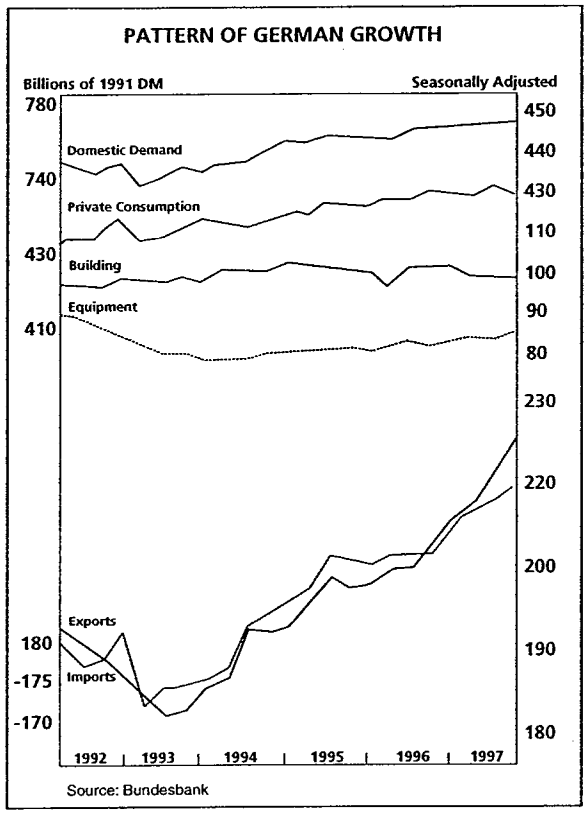
The table on page 7 reveals a perverse reality. With the first four countries, you see notorious high-consumption economies displaying vigorous growth of domestic demand. With the next six countries, you see the traditional high-savings, high-investment economies, all of them with very weak domestic demand growth. We have focused on this specific feature because we consider it of crucial importance.

	RECENT GROSS SAVINGS RATIOS IN PERCENT OF GDP	GROWTH OF REAL TOTAL DOMESTIC DEMAND IN PERCENT
UNITED STATES	15.9	4.1
UNITED KINGDOM	13.8	3.7
MEXICO	15.1	8.3
CANADA	17.1	5.5
GERMANY	21.3	1.3
FRANCE	19.7	0.9
JAPAN	30.8	-0.5
AUSTRIA	24.9	1.0
ITALY	20.5	1.3
SWITZERLAND	30.1	0.6

Source: OECD Economic Outlook, Dec. 1997

Obviously, the countries with high savings are, under present conditions, having trouble realizing the essential commensurate high investment ratios. Relative investment deflation is translating into employment and income deflation, and, obviously, this trend is not cyclical anymore but has become structural.

In theory, such a lack of investment spending might be remedied by higher consumer borrowing, as is typical in the United States and Britain, which have switched from investment-led to consumer-led recoveries. But in the high–savings counties, this has no chance of happening. Traditionally, banks and public opinion in these countries are prejudiced against heavy consumer borrowing. That's what gives them their high savings ratios.



The chart for Germany at the top right of this page highlights these deformations in the pattern of economic growth. New capital formation in the form of fixed investment has virtually collapsed. Though still at a high level, its growth has been deadlocked. In such high-savings countries, deflation begins when the rate of net investment starts to decline, which, in lockstep, leads to direct decreases in consumer incomes (remember the Multiplier Theory). More about this and its homemade causes in the next letter. Yet, in short, most European economies are choking amid punitive taxes and wages

DECEPTIVE U.S. ECONOMIC STRENGTH

But why is the U.S. economy apparently immune to these troubles? Why does it flourish while the economies in the rest of the world are withering? For Wall Street pundits, this must essentially be due to superior U.S. economic fundamentals. Indeed, it has a fundamental reason. But ironically, it is inferior fundamentals that make this possible. The basic reasons for the U.S. economy's stability and resilience are a lousy savings ratio — presently less than 4 percent of disposable income (versus 11-13 percent in Europe), and overabundant credit for consumption and financial speculation fueling persistent overconsumption. Europe, in short, lacks the spendthrift consumer who is willing to cut his savings to the bone.

We have clearly underestimated the durability of this U.S. recovery. But more important than timing is, in our view, the realization that this recovery is precariously based on obvious "bubble" effects that have elevated consumer spending temporarily to unsustainable levels at the expense of savings. The main impetuses behind this spending spree are 1) a borrowing binge, and 2) the extensive utilization of capital gains from the stock market boom. Its flip side has been the plunging personal savings ratio. It is ignored that such unsustainable, massive dissaving implies a grossly distorted growth pattern.

Against this backdrop of rampant credit and demand growth, any talk of beginning "deflation" in the United States appears really ludicrous. This is inflation all-out, even though it is not reflected in the price indexes. Stock price inflation has increasingly spilled over into domestic demand inflation, in particular into overblown consumer spending.

But having said this, we hasten to add that we regard the days of this inflationary boom in the United States as nevertheless numbered. Never to forget, this U.S. boom is bubble-bred, meaning that it is highly vulnerable to any accident. There are, indeed, lots of potential threats on the horizon: a sharply deteriorating U.S. trade balance, disappointing corporate profits, a bear market in stocks fueling a sharp decline in consumer spending, and a drastic deterioration in the high tech sector, which has been a very big contributor to economic growth.

BULL OR BEAR?

The familiar question remains with us: Has the bear market begun or does the bull still run? While we certainly lean to the former, the evidence is ambiguous enough for both bulls and bears to view the world somewhat confidently through their respectively colored glasses.

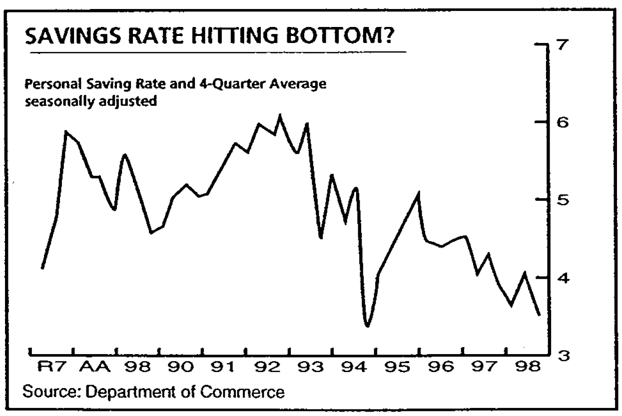
The bulls are much heartened by the inarguable market resilience and absolutely love the strong bond market. As the news from Asia goes from bad to worse and profit warnings and disappointments proliferate, the Dow and S&P 500 remain just a few percent below their all-time highs.

Most alarming really is the bad performance of the technology sector, after it has long been the star performer. With earnings disappointments now coming from all parts of the industry, many stocks have been crushed. And just when the beleaguered sector seemed ready for a year-end rally, this was abruptly terminated by a surprising earnings shortfall from Oracle. The following five-day drubbing hit even the seemingly untouchable leaders. Microsoft fell almost 15 percent, and Dell and Compaq even more than 20 percent.

The semiconductor SOX index now trades 30 percent below its earlier high and the Morgan Stanley High Tech and NASDAQ 100 19 and 15 percent below their respective highs. Previous highflyers Intel and Oracle now trade 30 and 50 percent below their August highs,

Also trading poorly, and now near its October 27 low, is the Russel 2000. Despite considerable cheerleading and unwavering bullish expectations, the small caps are once again underperforming, much to the consternation of the majority of mutual funds that are in general overexposed to this group.

Up to this point, the greatest negative effect on the market has been on companies directly impacted by the Asian crisis. Recently, however, we have seen subtle indications of concern about developing risks for the money center banks and Wall Street firms. After outperforming the market for most of the year, the likes of Chase Manhattan, Citicorp, Bankers Trust, Bank America, J.P. Morgan, Merril Lynch and Morgan Stanley Dean Witter have lately been underperforming. It strikes us that this is exactly the list of companies with truly massive derivative exposure. As we discuss below, we see plenty of cause for concern about this group now and beyond.



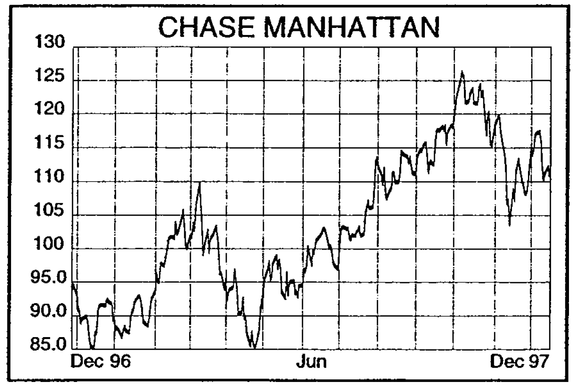
WHEN BANKS BECOME CASINOS

Essentially, the unprecedented speculative excesses in the U.S. and global financial markets over the past years have been mirrored by unprecedented changes in the activities and balance sheets of the major money center banks. The earmarks of this excess are ballooning positions in carry trade and derivatives as well as ballooning proprietary trading.

Now, with equity markets faltering, global currency markets in turmoil and an Asian financial crisis spiraling out of control, we thought it timely to take a closer look at U.S. money center banks, since they are

key players in this global game. The findings are alarming, despite the fact that investors rewarded the reckless speculative activity of the banking sector last year by pushing up the price of the average bank by 36 percent.

CHASE MANHATTAN

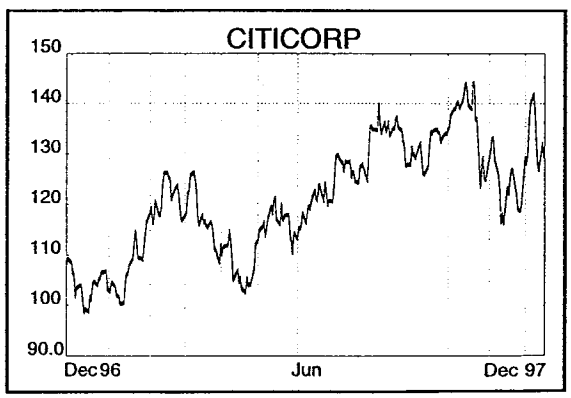


First we looked at Chase Manhattan, the largest U.S. bank. Studying the income statement for the second quarter (the latest available), one wonders why there would be any enthusiasm whatsoever for such a corporation. In fact, we would think anyone that takes a close look would not want to own such a company. Net interest income actually declined 1 percent year-over-year as the net yield on interest-earning assets declined to 2.81 percent from 3.15 percent. By business line, Consumer Banking net income declined 8 percent to $315 billion while Global Wholesale Banking grew 22 percent to $663 billion. Responsible for this portentous gain, total trading-related revenue grew 26 percent to $655 billion — this for just the one quarter! Interestingly, the biggest gains were in foreign exchange contracts, which grew 88 percent to $175 billion.

Looking at the balance sheet, one is struck by the fact that $21 billion in equity supports $352 billion of assets, of which only 44 percent are actual loans. Fully 42 percent of assets (over 700 percent of equity!), or $150 billion, were securities and trading positions. These were financed by repurchase agreements, a large part of which was foreign government issues. In other words, the famous international carry trade.

If the heavy use of financial leverage, creating a balance sheet loaded with domestic and international securities, is disconcerting.The off-balance sheet derivative positions are outright astronomical. In just six months, they show a startling rise by 28 percent to $7.4 trillion. How can anyone look at this and not see an accident waiting to happen!

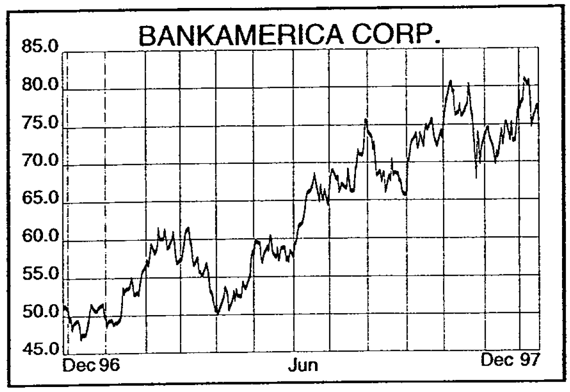
CITICORP



Looking next at Citicorp (CCI), one notes the same aggressive move into playing the securities markets. While net income from global consumer lending grew just 4 percent to $481 billion, Global Corporate lending soared 34 percent to $689 billion. Interest revenue from carry trade with securities, largely foreign, grew 20 percent to $448 billion. Foreign exchange revenues surged a noteworthy 96 percent to $435 billion

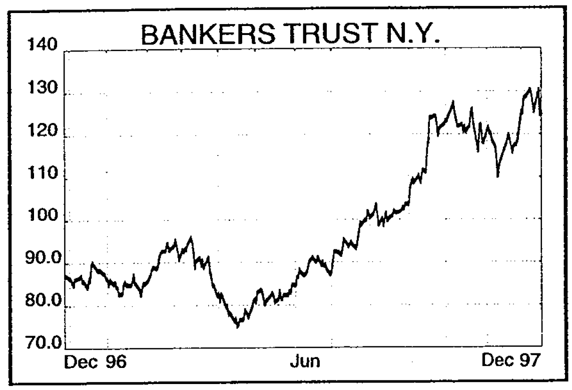
Looking at Citicorp's balance sheet, one sees $21 billion of shareholder's equity supporting $300 billion in total assets, of which 60 percent are loans. During the past nine months, total loans have increased less than 4 percent. Security positions, however, increased 17 percent to $82 billion, with foreign government securities increasing 22 percent to over $18 billion. As with Chase, the unknown but potentially huge exposure lies off-balance sheet. As of September 30th, Citicorp had over $3 trillion of derivative contracts outstanding, up 21 percent in just nine months. Leading the way was foreign exchange products, growing 27 percent to almost $1.8 trillion. Interestingly, equity derivative products grew by 127 percent to over $50 billion. As an aside, total stock repurchases since June of 1995 amount to $6.2 billion.

BANK OF AMERICA



On the other side of the country, in California, Bank of America (BoC) has pursued pretty much the same business strategy. With revenue from loans up only 4 percent, activity has been shifted aggressively into three areas for profit growth: carry trade, proprietary trading and derivative positions. Trading related income grew 46 percent to $223 billion, and gains from derivative positions rose 66 percent to $106 billion. From the quarterly report: "The improved performance for the first nine months of 1997 was largely attributable to BoC's trading activities in foreign exchange and emerging market debt securities in the second and third quarter of 1997."

BANKERS TRUST

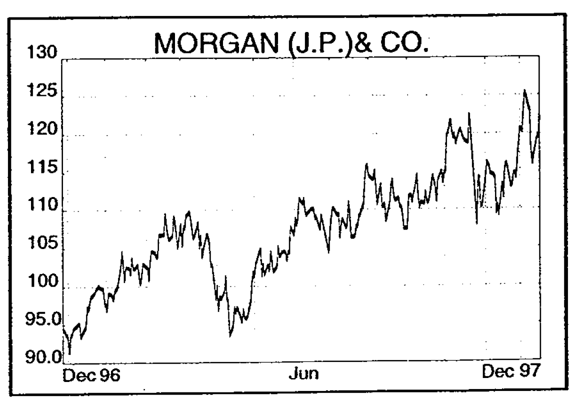


The most bizarre case is certainly Bankers Trust. Here $6 billion of equity supports $140 billion of assets, of which only $20 billion are loans. Trading assets are at almost 900 percent of equity. While interest revenue has grown but 5 percent during the past year, non-interest revenue has ballooned 48 percent: trading revenues increased 54 percent to $387 million, fiduciary and funds management is up 28 percent to $277 million, and corporate finance increased 58 percent to $305 million.

Actually, Bankers Trust looks much more like a highly leveraged hedge fund than a bank, but for one important difference: Typically, a hedge fund will take 20 percent of gains while leaving 80 percent for investors. In Bankers Trust's case, however, with incentive compensation and benefits rising 99 percent to $543 million, fully 60 percent of total revenue growth went directly into increases in compensation. As salaries, commissions and compensation increased $568 million, net income left for shareholders increased by a mere $44 million.

Why would anyone want to be a shareholder in such a business? If one ever wanted to see an example of truly exorbitant incentives guaranteeing extreme and ill-advised risk-taking and unjustly jeopardizing the firm's equity, look no further than Bankers Trust.

J.P. MORGAN



Of course, JP Morgan is also heavily exposed. Total assets — up 21 percent in the past nine months — are now $270 billion. Holdings of securities and financial instruments increased 23 percent to $221 billion while shareholders' equity rose a mere $200 million to $11.6 billion. Foreign government debt holdings expanded 20 percent and derivative contracts 34 percent. Trading revenue surged 29 percent to $657 million and income from investment banking 37 percent to $320 million. Off-balance sheet, JPM has over $3.5 trillion of derivative contracts outstanding, of which $943 billion are options it has written.

Observing such prodigious rates of growth in the financial positions of banks, we keep wondering how long this can go on. How liquid are these banks, and how liquid are the markets in which they operate with such vast sums when one day push comes to shove? A most alarming example was seen in the Korean currency market, normally a pretty active market. During four successive days, the local currency traded down its daily 10 percent limit, even though only very limited actual trading took place. Whereas the writers of put options expect and depend on liquid markets to mitigate risk, this is precisely the environment where they can be trapped with huge losses.

CONCLUSIONS:

The one important thing we can be sure of in 1998 is that inflation in the industrial countries promises to become even more subdued than at present. Already weak pricing power in tradable goods is going to evaporate under intense Asian export pressures even faster.

But the Asian crisis can only worsen. These economies are geared to very high savings and investment levels, as consumer and government borrowing are insignificant. By allowing their investments to go through monetary looseness to vast excess, they have ended up in savage debt, profit deflation and investment deflation. Depression looms. It will take years to absorb the inherent maladjustments.

While Europe is recovering, its growth remains fragile; it is definitely not growing swiftly enough to drag Asia out of its looming depression. South America and Eastern Europe also have been wounded by the East Asian meltdown.

In this light, it appears that but one thing is standing between the world and a global deflationary bust: the U.S. economy, acting as the inflator and buyer of last resort. Not since 1929 has the world economy's well being been so linked to the health of the U.S. economy. Then, however, the United States ruled by lending, today it rules by spending.

The U.S. economy has entered the new year with strong momentum. But the growth it has been enjoying has been bubble-bred, powered by unsustainable heavy consumer borrowing and stock market-related wealth effects. This U.S. economy is but a market break away from a serious downturn. Bubbles essentially end with a bang. As always, the low inflation rate blinds people to these dangers.

The chief risk factor both for the U.S. stock markets and the U.S. economy is the impending sharp earnings slowdown. This will finally shatter the prevailing New Era hype and, in sequence, puncture first the stock market bubble, second the spending bubble, and third the dollar bubble. A serious bear market would cause recession. The biggest risk for the Europe is a plunge of the dollar.

All this looks exceedingly benign for quality bonds, except for U.S. bonds.■

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